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CLIENT ADVISORY

SEC ISSUES NEW RULES TO PROTECT INVESTORS AGAINST NAKED SHORT SELLING ABUSES

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On September 17, 2008, the US Securities and Exchange Commission (SEC) issued a new emergency order taking temporary action to respond to recent market developments (the Order).[1] As part of the Order, the SEC adopted new rules and rule amendments aimed against abusive "naked" short selling of stock in all publicly traded companies, including companies in the financial sector. In a statement released yesterday, SEC Chairman Christopher Cox said that the SEC's actions "…make it crystal clear that the SEC has a zero tolerance for abusive naked short selling."

In traditional short sales, broker-dealers borrow shares that they then sell, with the understanding that the loan must be repaid by buying the stock in the market (hopefully at a lower price). But, naked short sales are short sales that are effected without any determination that securities will be available for delivery on the settlement date. The SEC's actions yesterday are the result of the continued concerns that investors are disrupting the functioning of fair and orderly securities markets by artificially driving down stock prices through naked short selling practices.

All of the new rules discussed herein became effective as of at 12:01 a.m. Eastern Time on Thursday, September 18, 2008, and terminate at 11:59 p.m. on October 1, 2008 unless further extended by the SEC.

I. Hard T+3 Close-Out Requirement; Penalties for Violation Include Prohibition of Further Short Sales, Mandatory Pre-Borrow

The SEC added, on a temporary basis, new Rule 204T to Regulation SHO (Rule). This new temporary Rule imposes a penalty on any participant[2] of a registered clearing agency,[3] and any broker-dealer from which it receives trades for clearance and

1 *See* SEC Release No. 34-58572 available at: http://www.sec.gov/rules/other/2008/34-58572.pdf.

2 The term "participant" has the same meaning as in Section 3(a)(24) of the Securities Exchange Act of 1934 (Exchange Act), which defines it to mean, when used with respect to a clearing agency, any person who uses a clearing agency to clear or settle securities transactions or to transfer, pledge, lend, or hypothecate securities. Such term does not include a person whose only use of a clearing agency is: (i) through another person who is a participant; or (ii) as a pledgee of securities.

3 The term "registered clearing agency" means a clearing agency, as defined in Section 3(a)(23)(A) of the Exchange Act, that is registered as such pursuant to Section 17A of the Exchange Act. Pursuant to Section 3(a)(23)(A) of the Exchange Act, the term is defined as any person who acts as an intermediary in making payments or deliveries or both in connection with transactions in securities or who provides facilities for comparison of data respecting the terms of settlement of securities transactions, to reduce the number of settlements of securities transactions, or for the allocation of securities settlement responsibilities. Such term also means any person, such as a securities depository, who: (i) acts as a custodian of securities in connection with a system for the central handling of securities whereby all securities of a particular class or series

settlement, for having a fail to deliver position at a registered clearing agency in *any* equity security. Specifically, new Rule 204T(a) requires a participant of a registered clearing agency to deliver securities for clearance and settlement on a long or short sale in any equity security by settlement date (three days after the sale transaction date, or T+3).[4] Or, if a participant has a fail to deliver at a registered clearing agency in any equity security for a long or short sale transaction in that equity security, by no later than the beginning of regular trading hours[5] on the settlement day following the settlement date, the participant must immediately close-out the fail to deliver position by borrowing or purchasing the securities in the market. Rule 204T, however, provides some relief from the T+3 close-out requirement in the following situations:

1. If there is a fail to deliver position at a registered clearing agency in any equity security and the participant can demonstrate on its books and records that such fail to deliver position resulted from a long sale, the participant has until the beginning of regular trading hours on the third consecutive settlement day following the settlement date to immediately close-out the fail to deliver position; or
2. If there is a fail to deliver position at a registered clearing agency in any equity security sold pursuant to Rule 144 of the Securities Act of 1933 (Securities Act) for 35 consecutive settlement days after the settlement date for a sale in that equity security, the participant must, by no later than the beginning of regular trading hours on the 36th consecutive settlement day following the settlement date for the transaction, immediately close-out the fail to deliver position.

In the event that a short sale violates any of the foregoing close-out requirements, then any participant or broker-dealer from which it receives trades, including any market maker, is prohibited under new Rule 204T(b) from accepting a short sale order in the equity security from another person, or effecting a short sale in the equity security for its own account, without first borrowing the security, or entering into a bona-fide arrangement to borrow the security, until the participant closes out the fail to deliver position and that purchase has cleared and settled at a registered clearing agency. This prohibition on the broker-dealer's activity applies not only to short sales for the particular short seller, but to *all* short sales for any customer.

Under new Rule 204T(c), the participant must notify any broker-dealer from which it receives trades, including any market maker: (1) that the participant has a fail to deliver position in an equity security at a registered clearing agency that has not been closed-out in accordance with the requirements above; and (2) when the purchase that the participant has made to close-out the fail to deliver position has cleared and settled at a registered clearing agency.

II. Exception for Options Market Makers from Short Selling Close-Out Provisions in Regulation SHO Repealed

The SEC approved final rule amendments to Rule 203(b)(3) of Regulation SHO that eliminate the options market maker (OMM) exception from Regulation SHO's close-out requirement for threshold securities. Specifically, Rule 203(b)(3)(iii) is revised to provide that, as of September 18, 2008 (the effective date of the Order), a OMM's fail to deliver position in a threshold security must be immediately closed-out (taking into account any adjustments to the fail to deliver position) within thirty-five consecutive settlement days of September 18, 2008, regardless of a previously applicable OMM exception. OMM's will now be treated in the same way as all other market participants.

Rule 203(b)(3)(v) has also been revised to include the same penalty provision discussed above in connection with Rule

of any issuer deposited within the system are treated as fungible and may be transferred, loaned, or pledged by bookkeeping entry without physical delivery of securities certificates; or (ii) otherwise permits or facilitates the settlement of securities transactions or the hypothecation or lending of securities without physical delivery of securities certificates.

4 For purposes of this new Rule, "settlement date" means the business day on which delivery of a security and payment of money is to be made through the facilities of a registered clearing agency in connection with the sale of a security.

5 For purposes of this new Rule, the term "regular trading hours" has the same meaning as in Rule 600(b)(64) in Regulation NMS—the time between 9:30 a.m. and 4:00 p.m. Eastern Time.

204T for persistent fails to deliver in threshold securities. Such penalty applies to participants and broker-dealers, including market makers, with a fail to deliver position in a threshold security for thirty-five consecutive settlement days from the effective date of the Rule amendment.

Note that the Order applies only to fails to deliver resulting from trades that occur *after* the Order becomes effective. Rule 203(b)(3) of Regulation SHO, as amended by the Order, continues to apply to fails to deliver that occurred prior to the Order becoming effective. Thus, if a participant or broker-dealer has a fail to deliver in a threshold security that has persisted for six consecutive settlement days prior to the effective date of the Order and the fail continues to persist until the 13th settlement day, the participant must still close-out its position pursuant to Rule 203(b)(3).

III. Rule 10b-21 Short Selling Anti-Fraud Rule

The SEC also added new Rule 10b-21, an anti-fraud rule that expressly targets fraudulent naked short selling transactions. The new Rule covers short sellers who deceive market participants and broker-dealers. Specifically, the new Rule makes clear that those who lie about their intention or ability to deliver securities in time for settlement are violating the law when they fail to deliver. Rule 10b-21 is not intended, however, to limit or restrict the applicability of the general anti-fraud provisions of the federal securities laws.

Some preliminary observations on the implications of the SEC Order are as follows:

- Although the Order pressures market participants and broker-dealers to deliver shorted securities by settlement date by imposing penalties for those failing to deliver in T+3, the SEC does not seem to impose an explicit market-wide pre-borrow requirement, as it did in its July 15, 2008, emergency order (the July 15 Order). The pre-borrow becomes mandatory under the Order only if the penalty is triggered. That being said, a pre-borrow *and* delivery requirement seems necessary in order to avoid a fail to deliver on settlement in the first place, and practical considering the penalty risks.
- Unlike the July 15 Order, it is unclear from this Order what the SEC's position is with respect to accepting customer assurances that a pre-borrow has been arranged (and documentation of the same), and reliance on "easy to borrow" lists.
- The July 15 Order applied to all "persons" (including non broker-dealers), while Regulation SHO applies only to broker-dealers that effects short sales for themselves or others. In this Order, however, the Order does not use the same pre-borrow language used in the July 15 Emergency Order, and instead speaks only to participants of a clearing agency and broker-dealers from which they receives trades in the context of close-out requirements. This could presumably exclude certain hedge funds and the like from the close-out requirements in the Order, even if they fail to deliver by settlement. Thus, in a situation where you have an investor (e.g., a hedge fund) looking to a prime broker to borrow and the hedge fund assures the executing broker that the locate has been done, it is the executing broker that is responsible for the delivery requirements under the explicit language of the Order. Nevertheless, both the executing broker and the hedge fund will likely need to pre-borrow as a practical matter due to penalty risks.
- For many broker-dealers (other than the largest broker-dealers), the effect of the Order could mean that participants and broker-dealers will not be able to offer short sale services to clients since they cannot take the risk that borrowed shares will not be delivered by settlement date. Similarly, participants and broker-dealers may be reluctant to face higher transaction costs associated with short sales.
- The Order's elimination of the OMM exception will make it harder for OMMs to hedge positions when they sell put contracts, which could ultimately effect the NASDAQ Stock Market and options markets.

In a further move yesterday, SEC Chairman Christopher Cox said he planned to ask the Commissioners to consider on

an emergency basis a new rule that would require hedge funds and other large-scale investors to disclose their short positions—the stocks they have borrowed and sold but not yet replaced.[6]

We hope that you find this advisory helpful. If you would like more information or assistance in addressing the issues raised in this advisory, please feel free to contact:

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6 *See* SEC Press Release at: http://www.sec.gov/news/press/2008/2008-209.htm.